The $5 Billion Answer

Testimony of
Bartlett C. Naylor
Director, Office of Corporate Affairs
International Brotherhood of Teamsters
U.S. House of Representatives
Committee on Commerce
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Mr. Chairman, members of the subcommittee, the International Brotherhood of Teamsters (IBT) appreciates the opportunity to offer our views on decimal pricing here today.

The IBT represents more than 1.4 million members. Teamster affiliated pension funds are valued at more than $59 billion. This is one of the largest pools of labor-associated capital existing. President Carey created the Office of Corporate Affairs to help insure that our members enjoy the full prerogatives that accrue with investment. To this end, Teamster affiliated funds have become among the most active and successful proponents of shareholder resolutions. We have nominated directors to boards, including the recently retired Patricia Schroeder for the Texaco board. We publish critical reports, including one released last week identifying what we called "America's Least Valuable Directors." Tony Coelho, one of Ms. Schroeder's Democratic colleagues figured prominently on this list. We follow Wall Street and have published reports on the pay-to-play municipal bond scandal, among other issues. We have testified in federal venues on securities litigation reform and serve a California blue ribbon task force on the same subject. We are plaintiffs in a number of successful lawsuits, including Teamsters V. Fleming which holds that shareholders have rights over boards regarding shareholder rights (a.k.a. poison pill) plans. Of late, we have campaigned (unsuccessfully) for reform of the S.E.C.'s position on employment-related proxy resolutions.

Decimalization is an easy issue for us. Bill H.R. 1053 seeks "To amend the Securities Exchange Act of 1934 to eliminate legal impediments to quotation in decimals for securities transactions in order to protect investors and to promote efficiency, competition, and capital formation." Naturally, we are concerned with protecting the rights of individual investors with respect to decimal pricing and the promotion of fiscal responsibility within various securities exchanges.

We support efforts to change stock price quotations from dollars and fractions to dollars and cents for equity transactions. We believe the savings that may be realized by investors is so sizeable as to command reform by the Securities and Exchange Commission and the New York Stock Exchange.

The History of Dollars and Fractions

Accidents of history, as opposed to thoughtful wisdom, inject numerous frictions into our currency, our markets, and our economy in general. Because of the vigorous debate regarding the balance of state and federal power combined with the practical fact that most commerce of the 18th century took place within communities as opposed to across state and national borders, we have state-chartered as opposed to federally-chartered corporations.

Similarly, because the currency of preference in 1790's New York City was the Spanish dollar, combined with subsequent practical fact that this has generated billions to Wall Street, we trade stocks on the New York Stock Exchange in "eighths" instead of decimals.

"Because of the ease with which the Spanish dollar could be chiseled into [pie-shaped] subdivisions, the Spanish Milled dollar was broken into as many as eight pieces known as "bits." Hence, the Spanish dollar was also know as the "piece-of-eight." (This also gave rise to the phrase "two bits," or 25 cents.)

In 1793, the Founding Fathers introduced decimal currency to America and the world one year after founding the exchange under the "Buttonwood Tree". But the anachronism of the "piece-of-eight" lives on in NYSE Rule #62 where "[B]ids or offers in stocks above one dollar a share shall not be made at a less variation than 1/8 of a dollar per share."

Cost to Investors

As a result of this anachronism, investors lose anywhere from $3 billion to $9 billion annually. For every penny saved per share, aggregate savings could be at least $1 billion, and up to $5 billion, according to market strategist Jeff Ricker (the latter figure assuming a nickel savings on every NYSE and Nasdaq trade). S.E.C. commissioner Steven M.H. Wallman estimates savings of $1.5 to $5 billion or more for investors. Junius W. Peake of the University of Northern Colorado said "when NYSE volume averaged only 250 million shares per day he estimated the total savings from decimal prices anywhere from $3 billion to $5 billion per year." Some academic studies suggest a potential annual savings to investors in U.S. stocks of $4-9 billion.

The "'insidious eighth' is the largest source of friction in our equity markets today," where "[it] averages about ten cents a share for an S&P 500 basket of stocks"--friction being one of two components of transaction costs to investors. "In U.S. markets the average bid-ask spread for an S&P 500 stock is 15.77 cents or 0.36% of the price. Typically, about 60% of the time these stocks are quoted with the minimum one-eighth spread;" sixty percent of the time, investors are being gouged, paying an extra 3 to 4 cents on each share of stock they buy, based on the Toronto Stock Exchange numbers.

Teamster funds are invested in a variety of ventures, including real estate, fixed-income and equity securities. Applying basic assumptions from academic studies, we estimate that savings to these funds alone in equity trades would amount to at least $21 million annually.

Understandably, our money managers offer mixed views of the proposed change, since some operate on both the "buy" and "sell" side of the market. We polled a sample of money managers retained by various Teamster affiliated pension plans. These included Chancellor Lgt. Asset Management, Cowen Asset Management, Bank of New York and Miller, Anderson & Sherrerd.

Their comments include:

"Decimal pricing would save investors money without having a major impact on liquidity."

"There would be a decline in the marginal trader."

"This might dry up some dealer capital, but wouldn't affect institutional transactions."

"When we take a stake in a company, we buy it for all clients, and we want a good price."

"It's important to maintain market-makers with the capital that can give you that good price".

"Wall Street survived the deregulation of commissions, so I expect it will survive decimalization."

"It's not a problem for our computers -- we already convert to decimals."

"It may be a wash, because we may get the eighth when we sell, and lose it when we buy."

"It's inevitable. Maybe one year, maybe five years."

Behind the Curve: The Big Board Conspicuously Lags Other Marketplaces

Among the top twenty exchanges throughout the world, the NYSE is among a lonely group that still trades in eighths. Currently all major foreign stock markets use decimal prices--the British converted in 1986, and Canada on April 15, 1996. The AMEX already prices securities under $10 in sixteenths and would price all of their listed stocks as such within 2 weeks of approval from SEC (NASDAQ may soon follow).

The Toronto Stock Exchange (TSE) converted to decimal pricing in April of 1996. "In the 11 months since the Toronto Stock Exchange made the switch, spreads have been cut by 21%, to an average of 20.5 cents, for most stocks trading above $5..." Daniel G. Weaver of the College of Business Administration at Marquette University found that since the TSE adopted decimalization, "execution costs decline for low priced and high volume stocks...a reduction in market depth" and that it has had a "negligible impact on trading profits" and "internalization" (a form of preferencing orders). At least, if exchanges in the United States made the change to decimals similar to that of Canada--.05 cents on stocks above $5.00 (from 12.5), .01 cents on stock priced $3.00 to $4.99--a conservative savings estimate of $5 billion per year would be passed on to investors.

Inevitably, exchanges in the United States will have to move to decimal pricing. Joseph Hardiman, CEO of Nasdaq cited pressure to compete with foreign markets as a good excuse for decimalization; "[O]ver time we will move to decimals." Even NYSE Chairman Richard Grasso told a conference in Chicago last October that "[T]here is no good argument for or against decimalization."

In 1994, the Securities and Exchange Commission conducted a study which recommended that the "tick price" be cut to sixteenths, from eighths, to be followed eventually by decimalization. This study has yet to be embraced by any of the major brokerage houses, trade associations or the NYSE. Richard A. Grasso, chairman and CEO of the NYSE noted that the NYSE "believes its unparalleled market liquidity and depth would not be enhanced by decimalization." In a statement released the following year he said "[W]e look forward to working with the committee and the S.E.C. in determining whether decimalization would be of benefit to investors," which may indicate the NYSE is finally willing to take a serious look at decimal pricing.

The Liquidity Scare

Opponents of a change to decimal pricing acknowledge the savings to investors, although this acknowledgement comes in the form of an argument regarding "liquidity." By draining some of the profit from trading, the market will lose some of its market-makers.

These "financial intermediaries" or market makers argue that a "seismic shift would eat into profits, rendering them unable to fill larger orders and leaving markets less liquid and more volatile..." causing the marketplace to "dry up." "I have great concern about stocks trading at 17 to 17-and-a-penny," stated the president of Herzog, Heine & Geduld Inc., E.E. "Buzzy" Geduld, one of the largest wholesale market makers. Yet, if the price is better by a penny, then it is a better price for the investor. "Many trading experts believe widely held Nasdaq stocks such as Microsoft Corp. and Intel Corp. would suddenly trade at spreads of about a nickel--a savings of $7.50 for every 100 shares bought or sold."

The fuller "nature" of the liquidity problem as a profit drain for Wall Street is more directly addressed by other officials. The chairman of the trading committee for the Securities Industry Association, Bernard L. Madoff said they "might be expected to resist a move that could potentially cut into brokerage profits." This is not surprising considering that equities traded in ticks of dimes, nickels or pennies would narrow the minimum spread on many of the most profitable stocks firms and their specialist units trade. Street specialists and market makers already admit that they make more money under eighths than they would under decimals, which seems to be the foundation for the opposition to decimal pricing. In fact, the specific intent of the bill is "to pare down the spread, to narrow the prices that dealers or specialists quote by using the decimal system," and to pass on the savings to the trading public.

Ignoring the irony that agents of the citadel of our free market economy should contend that competition would harm service, an assistant professor and Milwaukee's Marquette University studied the Toronto Stock Exchange and found the opposite. Daniel G. Weaver examined market makers' profits and other TSE members. "Not only were the professional middlemen able to continue making money--thanks mainly to shrewdly timed purchases and sales, or market timing--but they also saw commission revenue grow as the number of public orders jumped."

Cost of Conversion

Other Wall Street officials point to the high cost of conversion. Again, Junius Peake holds little sympathy for cost arguments against decimal pricing. "It's their own fault if they haven't gotten modern," he stated. With the inevitability of decimal pricing, the cost of converting trading systems to decimals will not be any less expensive if it is put off for a decade.

More recently, one official put the cost at several hundred million dollars. We appreciate the sensitivity of Wall Street officials to such costs, as we, too, are sensitive to such costs such as the estimated $8 billion paid in Wall Street trader bonuses last year. But such a cost pales when compared to the $3 billion + in investor savings. And such costs must be borne at some point. Commissioner Wallman argues that computer conversions would be one-time costs and many systems are already equipped to trade in decimals.

Conclusion

If stock markets and their administrators expect to help today's innovators attract capital to build tomorrow's industry, we ask them to embrace and not defend against technological innovation.

The NYSE features some of our nation's most impressive technological advances, attracting some of our brightest minds, from Fisher Black to Bill Gates & Co, whose personal computer innovations promise to further revolutionize financial intermediation, from Instinet to Naqcess and POSIT.

While the economic policy merits for decimalization weigh lopsidedly in favor of adoption, Wall Street will not easily unclutch the billions in annual revenue enjoyed from a 1780's trading system. The current benefactors are concentrated and the potential benefactors are widely dispersed. Indeed, we are hearing some extreme defenses. E.E. "Buzzy" Geduld, for example, raised the specter of the Red Scare: "Communism sounded good too, until it became real."

Good economic policy on this issue depends on the brave actions of our Securities and Exchange Commissioners and their Congressional overseer's, and I commend the Committee and the co-sponsors of the bill for their bold leadership.